services. The long distance industry already has developed the necessary infrastructure to support a multi-vendor, competitive environment.

Q. WILL BELLSOUTH BENEFIT FROM THIS MULTI-VENDOR INFRASTRUCTURE WHEN IT IS PERMITTED TO PROVIDE INTERLATA SERVICES IN ITS TERRITORY?

A. Yes. BellSouth is in a position to capitalize on the fruits of the long distance industry's history with competition. Once legal authority is granted, BellSouth could begin offering long distance services without investing in a single switch or strand of optical fiber, without obtaining a single right of way, or negotiating a single interconnection agreement with a recalcitrant monopolist. BellSouth simply would need to choose an underlying interexchange network supplier (indeed, it has already chosen AT&T for just this purpose) and begin marketing long distance services to its preexisting base of local customers, a base which today is the *entire* market in its exchanges.

BellSouth's path to becoming a long distance carrier is well-established, tested and routine. It is a feat accomplished by thousands of firms since divestiture. Assisting BellSouth in its task of adding long distance service is a competitive long distance market with four national networks (plus a number of regional networks). Local exchange company operational systems (i.e., presubscription processes) are already sized to process large numbers of consumer requests to change long distance carriers. Moreover, consumers are accustomed to changing long distance providers.

Q. **WILL BELLSOUTH BENEFIT FROM COMPETITIVELY ESTABLISHED WHOLESALE PRICING IN THE INTEREXCHANGE MARKET?**

A. Yes. According to published reports, BellSouth negotiated a discount of approximately 85% from prevailing long distance retail rates (net of access).[2] This discount is the result of a competitive wholesale market that actively solicits retail carriers with attractive wholesale pricing and operational systems specifically designed for resale. This discount is also in-line with the discount that NYNEX had previously indicated to Wall Street analysts that it anticipated on its interLATA traffic.[3]

Q. **IS THERE AN EXAMPLE WHICH DEMONSTRATES HOW SIMPLE IT WILL BE FOR BELLSOUTH TO PROVIDE LONG DISTANCE SERVICES TO CUSTOMERS IN ITS REGION ONCE IT IS AUTHORIZED TO DO SO?**

A. Yes. GTE provides a useful example of how quickly an incumbent local exchange carrier can offer long distance services and provides a telling contrast to the difficulty that AT&T and other local entrants must overcome. It took GTE *less than one hour* from the Act's signing to contract with an underlying carrier for the services and facilities needed to provide long distance services. The ease of entry experienced by GTE did not go unnoticed by Wall Street. As Merrill Lynch reported:[4]

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[2] BellSouth/AT&T Contract Reinforces the RBOC/GTE Investment Case, Merrill Lynch, June 20, 1996.

[3] Source: Dean Witter, November 6, 1995.

[4] Telecom Services, Merrill Lynch, May 14, 1996, page 6. Emphasis in original.

> GTE has already begun to offer long distance services to its in-region customers and intends to gain 10% of its $4.8 billion addressable long distance market within 12 months with negligible cost to the bottom line. GTE management presentations at its quarterly analyst meeting reiterated the company's plans to achieve 10% EPS growth for the foreseeable future, despite the "negligible" startup cost of long distance entry. We also learned the company believes its long distance effort will generate positive earnings impact in 1997, which reflects, in our view, the remarkably attractive economics facing an RBOC entering an adjacent market (long distance). **How often is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new service without noticeable dilution and achieve positive earnings by the second year?**

This analysis embodies every conclusion of the market dynamic I have described above. GTE expects to gain -- and in fact, is gaining -- share rapidly. GTE expects to do so with negligible costs. GTE's opportunity is *immediate* higher profits and market share. In fact, GTE's management expects its profitability to grow for the "foreseeable future."

BellSouth's opportunity is no different. Merrill Lynch has termed long distance service for an RBOC such as BellSouth as the "ultimate" vertical service, noting:[5]

> We [Merrill Lynch] use the term *ultimate* because, like other vertical features, long distance can be offered to already existing customers with *minimal capital investment, but unlike vertical features, customers do not have to be convinced to use it.* They already are using it; they just need to be convinced to change suppliers -- something they do every day . . . .

[5] Telecom Services - RBOCs and GTE, Merrill Lynch, August 9, 1996, page 4, emphasis in original.

Q. **WHAT WOULD BE THE EFFECT OF BELLSOUTH'S ENTRY INTO THE LONG DISTANCE MARKET WITHOUT FIRST ESTABLISHING WIDE-SCALE LOCAL COMPETITION?**

A. If a large portion of the market prefers to obtain its telecommunications services as a package -- and this perspective appears borne out by GTE's experience -- then the absence of competition for *any* element of the package (i.e., local exchange service) would distort competition for *all* services that are, (or, more precisely, will be) sold as a package. Because local exchange service will likely be seen as a compulsory element of the package in the eyes of many (if not most) consumers, local service *must* become competitive or competition for other services, such as long distance, will suffer.

The re-creation of the Bell System monopoly is not what Congress intended or consumers deserve. The Bell System divestiture was successful. Barriers to long distance entry were greatly reduced, AT&T lost its monopoly, fiber and digital technology were rapidly deployed, prices fell, and consumers enjoyed choice in virtually every market. The Act essentially extends the pro-competitive policies of the Bell System divestiture to all services. Just as divestiture provided AT&T's competitors with access to the local network on equal terms in order to originate and terminate long distance calls, the Act makes the local exchange network available to competitors on equal terms for *every* purpose, including the provision of local exchange and exchange access.

C. The Tools Of Comprehensive Entry: Resale And Network Elements

Q. HOW WILL COMPETITION PROCEED DESPITE THE DOMINANCE OF BELLSOUTH'S NETWORK?

A. Congress recognized the massive dominance of the incumbent LEC's network and the reality that it will take many years for the local transmission (especially loop) market to become as competitive as the interexchange transmission market. Alternative networks will take time to develop. As a result, the Act provides for a number of entry strategies that rely, to one extent or another, on the immediate use of BellSouth facilities and services by other providers.

Each of these strategies can be found in the central components of AT&T's requests that led to this arbitration. These key components include AT&T's request to:

- resell wholesale equivalents of BellSouth's retail services,
- provide local exchange and exchange access services using network elements -- including complete combinations of network elements -- obtained from BellSouth as basic ingredients to AT&T's services, and
- the transport and termination of traffic under reciprocal compensation arrangements.

In later sections of my testimony, I address more extensively the importance of network elements (Section IV) and reciprocal compensation (Section V) to providing exchange services. The point that I would like to emphasize here is the significance of *comprehensively* establishing the basic conditions of local competition. Comprehensively opening the local market by establishing the full range of entry options is important because not every entry strategy is appropriate for every customer or market.

There are at least three features of a comprehensive arbitration request that set it apart: (1) the intended *scale* of entry; (2) *applicability* to other entrants; and, (3) the need for systems to support customer choice with a *convenience* already accepted in the market.

Q. WHAT DO YOU MEAN BY "SCALE OF ENTRY"?

A. By scale of entry I mean AT&T's ability to broadly address its existing base of subscribers. No single entry vehicle is best suited for every customer and geographic consideration. Some strategies -- loop resale for instance -- are particularly ill-suited for mass application because they either require physical circuit rearrangements as customers move between providers or presuppose the extensive deployment of alternative networks which do not now exist. Broad entry requires that the full range of entry strategies be available so that a carrier may tailor its offerings to particular conditions.

Q. WITH RESPECT TO YOUR SECOND POINT, HOW IS AT&T'S PROPOSED INTERCONNECTION AGREEMENT APPLICABLE TO OTHER ENTRANTS?

A. Because AT&T's request is so comprehensive, its value extends beyond this single entrant to an entire industry. By encompassing all possible entry strategies, AT&T's request necessarily includes the individual approaches that other carriers will use to address their markets. This observation is particularly important. By deciding this arbitration, the Commission is establishing the conditions of entry not just for AT&T, but effectively defining the minimum entry conditions for any entrant that will use all (or part) of BellSouth's network to provide local services.

Q. PLEASE EXPLAIN WHY AT&T'S COMPREHENSIVE REQUEST EMPHASIZES OPERATIONAL DETAIL.

A. Just as the development of meaningful long distance competition required new systems to support a multi-vendor environment, meaningful local competition will not succeed without a similar commitment of industry resources to operational support. This is an important issue because consumers will widely perceive local competition -- and the Congressional action upon which it relies -- as a failure if changing local telephone providers is associated with extended delays, high costs, periods of outage, unreliable bills, or disrupted services. Operational systems are absolutely critical to robust competition in the local exchange market.

The process with which consumers are familiar -- and which BellSouth some day will use to enter the long distance market -- allows consumers to change long distance carriers (i.e., their primary interexchange carrier, or PIC) with a simple telephone call or stroke of the pen. It is an easy, streamlined process. The operating standards of this process, in terms of cost, speed and accuracy, should become the standard for judging systems used to change local service providers as well.

Q. DO THE FCC'S RULES REFLECT THIS PERSPECTIVE THAT A CONSUMER'S DECISION TO CHANGE LOCAL PROVIDERS SHOULD BE AS SIMPLE AS THE PIC-CHANGE PROCESS?

A. Yes. Rule §51.319(c)(1)(ii) includes the requirement that wherever the change in the customer's local service provider is accomplished through a software event (i.e., resale arrangements or configurations using unbundled local switching), the change in a customers' local service provider must occur in an interval no longer than the interval in which an incumbent LEC transfers end-users between interexchange carriers.

D. Entry And Facilities Deployment

Q. **WILL THE RESALE OF WHOLESALE SERVICES AND ACCESS TO NETWORK ELEMENTS SPUR NETWORK CONSTRUCTION?**

A. Yes. These tools are essential for local competition to proceed and to provide the appropriate foundation for the network construction that will continue for the indefinite future. The Department of Justice recently reached the identical conclusion, noting in its comments to the FCC (Docket 96-98, page 37) that:

> Reducing entry barriers into local markets by permitting resale [of wholesale services] and cost-based access [to network elements] is much more likely to lead to the greater development of facilities-based competition than would occur absent such access and resale opportunities.

Entry using BellSouth's network will permit entrants to build the necessary revenue streams to justify the massive investment necessary to construct even relatively modest local networks. As entrants build their base of customers using wholesale services and unbundled network elements, they then will be able to make rational investment decisions concerning where to construct networks, invest in switching, add new capabilities, etc.[6]

Q. DOES THIS PROCESS PARALLEL THE DEVELOPMENT OF FACILITIES COMPETITION IN THE LONG DISTANCE MARKET?

A. Yes. In the long distance market, early entrants like MCI were able to expand their services and customer base by reselling services off of AT&T's network. This growth financially justified the deployment of their own networks, providing internal investment capital and shareholder confidence, and encouraged the entry of others, including (what is now) the third major network provider, Sprint. Later, the continued growth of the resale market resulted in the construction of the *fourth* national network (WilTel) for the express purpose of providing wholesale carrier-to-carrier services for use by the "resale" industry.

Q. WILL NETWORK CONSTRUCTION BE INSTANTANEOUS?

A. No. Local facilities deployment is a long-term proposition. It took the Bell operating companies more than 100 years to achieve the present state of the network and the Commission should not expect entrants to deploy comparable networks overnight.[7]

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[6] Teleport, in fact, has publicly stated that its business strategy is to win customers first and then build facilities in an efficient way to serve them (Telecommunications Reports, October 16, 1995, page 20).

[7] The Commission also should recognize that the Act provides a strong, potentially threatening, incentive for local network investment, that is, BellSouth's becoming a long distance company. This single action will transform BellSouth from the long distance industry's principal *supplier* to its principal *rival*. Long distance companies will not want to be as dependent upon BellSouth as they are today once BellSouth becomes their main competitor. Each will construct, and encourage the construction by others, of other networks in as short a time as possible.

Q. DO YOU EXPECT CARRIERS WILL REPLICATE THE ENTIRE BELLSOUTH NETWORK?

A. No. It is likely that some portions of the network may never see a competitive alternative, certainly in the next several years. For instance, it is easy to visualize significant resistance on the part of residential homeowners to multiple network interface boxes being installed on their premises to reflect previous, and future, competitive choices in local services. Other elements of the network may best be provisioned by a sole network vendor (for instance, the loop and local switching in many areas). The point is not simply to encourage new construction -- the goal is to encourage *efficient* facilities deployment. Wholesale services and economically priced unbundled network elements are key elements of this transition.

III. LOCAL SERVICES RESALE

Q. WHAT IS LOCAL SERVICES RESALE?

A. Local services resale is the purchase of an incumbent LECs services by a competing local service carrier on a wholesale basis with the intent to resell these services to consumers. Wholesale local services are expressly designed, supported, and *priced* to be resold by another carrier in the retail market. These wholesale local services provide multiple entrants a simple means to begin offering local exchange services and attract customers. BellSouth is required to offer its local services for resale at wholesale rates under Section 251(c)(4) of the Act.

Q. **WILL LOCAL SERVICES RESALE PROVIDE IMMEDIATE CONSUMER BENEFITS?**

A. Yes. In the long distance marketplace today, many carriers buy long distance services at wholesale rates for purposes of reselling them to customers, and compete by differentiating their billing systems, customer support and other elements of services. This same strategy can be extended to the local marketplace, with carriers using their marketing and customer skills to resell services obtained from the incumbent LEC.

Q. **WILL LOCAL SERVICES RESALE PROVIDE AN EFFECTIVE CHECK ON BELLSOUTH'S PRICING?**

A. Only in small ways. Requiring BellSouth to provide wholesale local exchange services will limit its ability to discriminate between classes of customers, except where the Commission has blessed such discrimination to satisfy a unique public need (such as, for instance, preventing LifeLine services from being offered outside the targeted class).

Wholesale services, however, will not police the overall level of rates as effectively as the pricing of unbundled network elements and interconnection as discussed earlier in this testimony. This is because the wholesale price is calculated off the retail rate. As retail prices move up, so too do wholesale rate levels, and price competition is constrained by the differential. As a result, only limited price competition is made possible by reselling wholesale services. Thus, the need to regulate BellSouth's retail rates remains unchanged.

Q. SHOULD ALL RETAIL SERVICES HAVE A WHOLESALE EQUIVALENT?

A. Yes. There are a number of strategies that BellSouth could use to limit the usefulness of the wholesale option. Several of the agreements which have been reached recently -- importantly, with carriers that have little or no interest in reselling BellSouth's services -- expose this strategy. In particular, BellSouth proposed to AT&T several exclusions to its wholesale pricing and resale obligations.

These exclusions could be used by BellSouth to effectively evade its wholesale obligation by selectively targeting customers for special pricing, rolling promotions, and grandfathering, which is a more polite phrase for warehousing, large sections of the market. Together, these exclusions could eliminate the wholesale option as an entry option.

Q. WHAT IS THE BASIC APPROACH TO CALCULATING THE WHOLESALE PRICE FOR LOCAL SERVICES?

A. The basic approach is to remove from the retail price an estimate of the retail-related costs that will be avoided by BellSouth as a wholesaler of services. This perspective also underlies the FCC's rules relating to wholesale pricing.

Q. WHAT WOULD OCCUR IF THE COMMISSION DOES NOT FULLY REMOVE THESE RETAILING COSTS WHEN ESTABLISHING THE WHOLESALE RATE?

A. Failing to fully remove retail costs would create a wholesale rate level that is too high. This would distort competition and artificially depress entry. The effect would be to deny consumers the benefits of competition -- lower prices, more choices and the ability to vote their dollar between rivals vying for their attention.

It is useful to remember that although the immediate recipient of a wholesale discount is the local reseller, the ultimate beneficiaries are consumers. An artificially low wholesale discount will not lead to lower retail prices. In other words, the smaller the discount, the less competitive pressure to lower prices.

Q. **ARE THERE ANY MARKET "BENCHMARKS" TO JUDGE THE REASONABLENESS OF THE PROPOSED DISCOUNTS?**

A. Yes. In the long distance market there is a competitive wholesale market that actively solicits retail carriers with attractive wholesale pricing and operational systems specifically designed for resale. It is useful to consider the discounts that the RBOCs have trumpeted to Wall Street analysts to place the local wholesale discounts discussed in this proceeding into context.

For instance, NYNEX recently indicated to Wall Street analysts that it anticipated a 80% discount on the long distance services it buys at wholesale. (Source: Dean Witter, November 6, 1995.) Further, Merrill Lynch (Merrill Lynch, August 24, 1995) states:

> reseller spreads in long distance are already huge (50%) given the existence of four fiercely competitive long distance networks.

Merrill Lynch also predicts that:

> For calls terminating outside an individual RBOC's franchise area, that RBOC will be able to bargain for volume discounts given that its volumes are likely to exceed that of any other long distance customer in that region -- *discounts that are likely to grow over time as RBOC long distance shares and thus negotiating leverage grows.*

Emphasis added.

The point here is simple: where *competition* decides the wholesale discount, that discount is large and is expected to increase.

IV. UNBUNDLED NETWORK ELEMENTS

A. *The Nature Of Unbundling*

Q. **PLEASE DEFINE "UNBUNDLING."**

A. Unbundling refers to the offering of discrete elements of the incumbent's network as generic functionalities, not as finished services. These network elements are "unbundled" from each other (i.e., they can either be purchased separately or in combinations) and from the retail services of the incumbent LEC (i.e., the finished service is decided by the purchaser of network elements, not BellSouth).

A useful metaphor for unbundling is that of the "Chinese Restaurant." Chinese restaurants typically have extensive menus, detailing dozens of selections. Yet, in the kitchen, only a few basic ingredients are used to create all these choices. Similarly, telecommunications services are typically constructed from a limited number of key ingredients (switching and transmission are the most basic), but the variety of services (from the consumer's perspective) can be quite extensive. Unbundling represents the availability of the incumbent's network elements as ingredients to other providers so that they may combine these ingredients (sometimes adding their own, sometimes not) to provide their own finished services.

Q. **IS UNBUNDLING THE SAME AS RESALE?**

A. No. Resale involves the purchase of *finished services* by the reseller from the incumbent LEC (albeit at wholesale rates) which are then resold by the reseller. Unbundling is the purchase of underlying *network elements* -- which may be facilities, functions or capabilities -- that can be combined to offer services, either equal to, or different from, the services of the incumbent LEC.

Q. **WHAT ARE THE POTENTIAL BENEFITS FROM UNBUNDLING?**

A. There are three primary benefits. First, opening the incumbent's network to other carriers as a menu of generic ingredients will make robust competition possible despite the dominance, if not complete monopoly, of the incumbent LEC's network. New entrants could fashion service packages not now available, providing consumers additional choices.

Second, unbundling allows carriers to sequentially replace individual components of BellSouth's network as competitive networks slowly develop. The enormity of BellSouth's network necessarily implies that the process of facilities deployment will take time, and will occur unevenly throughout its region. However, through unbundling, carriers will have an opportunity to develop markets, establish services, and attract consumers on a timely basis in the *entire* market, with the process of facilities-deployment following wherever economic.

Third, with unbundling there will be substantially more choices at the end of the process than would result if each individual entrant had to construct network facilities in order to offer services. Unbundling prevents local network deployment from becoming a prerequisite to offering service, both for today's entrants and new providers that may form in the future. By creating an open entry environment, investment capital can be directed to developing new services and applications, rather than used exclusively to replicate transmission and switching facilities. By eliminating barriers to entry, the most diverse competitive environment will develop.

Thus, unbundling has the potential for *immediate*, *transitional* and *long lasting* benefits for the local exchange market and South Carolina consumers. What matters most at the end of the process is that multiple carriers have the opportunity to broadly approach the South Carolina marketplace, designing services which they believe best satisfy the needs of their customers, on an economic basis similar to that of BellSouth, and fully supported by operational systems which will easily accommodate choices by consumers.

A full description of the most fundamental elements that should be unbundled immediately is provided in the testimony of AT&T Witness John Hamman.

B. The Economic Pricing Of Network Elements

Q. HOW SHOULD NETWORK ELEMENT PRICES BE ESTABLISHED?

A. Network element prices set at forward looking, long-run incremental costs will yield the greatest choice and benefits to South Carolina consumers. To maximize competition – that is, to promote an environment that will present South Carolina consumers with the greatest diversity of pricing plans, calling options, and service features – it is important that the underlying exchange network be available to *all* retail providers of local exchange services on the same terms, conditions and prices.

There are only two ways to assure that all providers have access to the exchange network on equivalent terms. The first is to prohibit the network owner from offering competitive services at all. This was the basic approach that underlaid divestiture; for obvious reasons I am not recommending that action here.

In the absence of such structural protection, however, the only viable mechanism is to establish prices of the underlying network components at their forward looking, long-run incremental cost. The key is to make the network available to all providers on equivalent terms. For the incumbent LEC, this is the element's Total Service Long Run Incremental Cost (TSLRIC). Because carriers are purchasing *elements* and not finished *services*, the FCC has adopted the term Total Element Long Run Incremental Cost (TELRIC) to emphasize this distinction. So that all providers face the *same* effective cost for the use of the network. the *price* charged other carriers must be equal to the forward looking, long-run incremental cost. AT&T witness Michael Harper provides additional details concerning the appropriateness of TELRIC pricing for network elements.

Q. **DOES PRICING NETWORK ELEMENTS AT TELRIC IMPLY THAT BELLSOUTH WOULD NOT BE ALLOWED TO EARN A PROFIT OR COVER ALL OF ITS ECONOMIC COSTS?**

A. No. First, (TSLRIC) includes a return on investment sufficient to attract and retain capital. Although commonly referred to as "profit," the "cost of capital" is a legitimate economic cost and is included in TELRIC.

Second, under the TELRIC methodology adopted by the FCC, the price of network elements should collectively recover the forward looking, long-run costs of providing network elements, including the costs of the managerial and administrative functions necessary to support these network elements. These managerial and administrative costs, while directly caused by network elements in the *aggregate*, however, cannot be attributed *individually* to specific network elements. Because of the presence of these "forward looking common costs" of providing network elements, the FCC's rules permit the price of each *individual* network element to be increased above its individual TELRIC to recover a portion of the *network-element-related* common costs.

Q. **ARE ALL COSTS INCURRED BY BELLSOUTH INCLUDED IN THE TELRIC?**

A. No. There is a category of costs -- the costs associated with product development, marketing, and advertising that support BellSouth's retail operations, as well as financial and managerial costs that would be incurred whether BellSouth owned and managed its network or not -- that have no relevance to the costing of network elements. These costs are not incurred to provide network elements or functions. However, this does not mean that these costs will go unrecovered. It only means that BellSouth must be as efficient as its rivals, who must recover similar costs in the prices of their services.

C. Carrier-To-Carrier Interconnection Arrangements And Consumer Rate Levels

Q. HOW CAN FULL IMPLEMENTATION OF THE ACT BE EXPECTED TO BENEFIT CONSUMERS?

A. The Act is fundamentally about choice. Choice for consumers is made possible through the interconnection agreements arbitrated by this Commission that will underlie the service offerings of new entrants. This is why correctly arbitrating such carrier-to-carrier arrangements is so important -- these interconnection agreements ultimately translate to the choices and price levels that consumers experience. Much as the visible contours of the earth's surface (its mountains, valleys and plains) are determined by underlying geographic conditions, so too will consumer choices and prices be decided by the underlying conditions of this Commission's arbitrated interconnection agreements.

Q. HOW WILL PRICES FOR UNBUNDLED NETWORK ELEMENTS INFLUENCE RETAIL RATES?

A. BellSouth's competitors will use unbundled network elements to provide local exchange services to consumers and exchange access services to other carriers. With correctly priced network elements and local call termination (which is to say, prices based on forward looking, long-run incremental cost), these entrants will be able to offer -- and competition will force successful entrants to offer -- local exchange services at prices no higher than today's prevailing (i.e., BellSouth's) rates.

Importantly, once competition is established by entrants offering service using unbundled network elements and call termination, the existence of multiple providers of local exchange services will constrain BellSouth's own pricing behavior. BellSouth will not be able to raise local exchange prices because consumers will have a choice of other providers. There is simply no consumer protection stronger than the ability to "take your business elsewhere."

However, the entire basis for the above conclusion is that the network element and call termination arrangements used by the entrant are priced at forward looking, long-run incremental cost. If so, then the entrant and BellSouth each will face the same underlying cost of the facilities needed to provide service. So long as these carrier-prices facilitate profitable initial entry, then competition should provide sustained pressure on price levels in the future.

Q. **WHAT WOULD HAPPEN IF THESE PRICES ARE INFLATED ABOVE THEIR COSTS?**

A. The result would be higher consumer prices and fewer choices. BellSouth would be able to increase the costs of its rivals, limiting their ability to compete with lower prices.

Q. **IS THIS WHY THE COMMISSION SHOULD MAKE SURE THAT UNBUNDLED NETWORK ELEMENT AND CALL TERMINATION PRICES ARE ESTABLISHED CORRECTLY?**

A. Yes. The Act begins a fundamental shift in regulatory focus from *directly* setting retail prices and service dimensions (such as the size of local calling areas) of local exchange carriers, to *indirectly* influencing retail services through the review of the underlying carrier-to-carrier arrangements. If unbundled network elements and call termination prices are correctly established, then both BellSouth and other providers will be able to compete upon a common foundation, at least with respect to the cost of the underlying network.

Q. **PLEASE DESCRIBE THE TRANSITIONAL SURCHARGE THAT HAS BEEN STAYED.**

A. The FCC adopted a transitional surcharge equal to the sum of two interstate access rate elements: the carrier common line charge (CCLC) and 75% of the "transport" interconnection charge (TIC). The first surcharge, the CCLC charge, recovers a portion of the cost of local loops that had been assigned to the interstate jurisdiction. The second, the TIC, is an interstate charge designed to provide BellSouth with "revenue neutrality" when transport rates were restructured. The FCC Rules that would have permitted BellSouth to impose this surcharge have been stayed.

Q. WHAT WOULD HAVE BEEN THE IMPACT OF THE FCC'S SURCHARGE?

A. The FCC's surcharge would have significantly reduced the value of unbundled local switching as a viable option to broadly approach consumers. Using interstate data provided in BellSouth's 1996 interstate price cap filing, I estimate that the increase in cost caused by the FCC's interim plan would have been approximately $3.82 per subscriber line served by an unbundled switch. This interim surcharge would raise the *cost* to other carriers to offer local exchange service -- and, ultimately, the *price* that would otherwise exist for local exchange service paid by consumers -- by almost $4.00 per line. As noted, this portion of the FCC Rules was stayed. However, to prevent any misunderstanding, this Commission should clearly prohibit, even for an interim period, any additional surcharge on unbundled local switching.

V. LOCAL CALL TERMINATION

Q. ARE ACCESS AND CALL TERMINATION IDENTICAL?

A. Yes. The functionality to terminate a call is the same whether the call is classified as a "local" call or a "long distance" call. A pricing issue arises, however, because the charges to long distance carriers to terminate toll traffic (i.e., access) are far above cost.

Q. **WHY ARE CALL TERMINATION PRICES SO IMPORTANT?**

A. The prerequisite to any form of telecommunications competition is the ability to complete calls to other subscribers, virtually all of whom (within BellSouth's exchanges) are served by BellSouth. In this regard, the introduction of local competition is not unique. Whether a call is labeled local, or long distance, it still must be terminated to the customer.

Q. **WHY IS IT IMPORTANT THAT RATES FOR TRAFFIC TERMINATION ULTIMATELY BE THE SAME FOR "LOCAL" AND "LONG DISTANCE" TRAFFIC?**

A. One of the potential benefits of full service competition is competitively determined "local" calling areas. In a competitive market, the "local" calling area should become an important dimension of product differentiation, with carriers offering a variety of price and boundary packages to consumers.

The key to establishing competitively determined local calling areas is correctly pricing access/termination service so that a carrier's cost to complete a call is not dependent upon BellSouth's retail classification. If both access (for "toll") and termination (for "local") charges are the same, then carriers will be free to design products with differing boundaries, with the goal to attract subscribers by offering a "better" local calling area.

Such an environment, however, absolutely requires non-discriminatory termination rates that do not attempt to differentiate between types of calls. Otherwise, all carriers would have their cost-structure defined by BellSouth's retail rate structure --

a low cost to terminate a "local" call, a higher cost to complete a "toll" call -- and BellSouth's local calling boundaries would dominate the market.

A far better outcome is based on non-discriminatory, cost-based charges for call termination, irrespective of any *label* on the call. With such non-discriminatory charges, carriers would be free to decide the scope of their own local calling areas, sizing these areas to match their own perception of the market and to reflect their own pricing and marketing strategies. In this way, the market -- which is to say, *consumers* -- would decide the size and shape of the local calling area as carriers compete along this important dimension of service.

Q. ARE THERE OPERATIONAL EFFICIENCIES TO BE GAINED BY NON-DISCRIMINATORY, COST-BASED ACCESS CHARGES?

A. Yes. For BellSouth to enforce a price differential between "interexchange access" and "local termination," BellSouth would need to require that all competitors adopt the same definition of local calling <u>and</u> BellSouth would need to implement auditing systems to correctly assess its charges. Such systems are not only unnecessary, but they would cause both BellSouth and the entrant to needlessly incur costs solely to accomplish an unreasonable result: the continued discrimination between local and long distance calling.

Q. DOES BELLSOUTH AGREE THAT CALL TERMINATION PRICES SHOULD BE NON-DISCRIMINATORY?

A. Yes. In BellSouth's Comments to the FCC on these same issues (CC Docket No. 96-98, page 63), BellSouth recommended that:

> The [Federal Communications] Commission should take a comprehensive view leading to a common model for interconnection that is not based on classification of carriers as LECs, IXCs, CMRS providers, or ESPs.

Similarly, this Commission should strive to implement a comprehensive cost-based pricing system which does not discriminate between types of calls or carriers.

Q. IF TERMINATING LOCAL CALLS AND TERMINATING LONG DISTANCE CALLS ARE IDENTICAL, WHY SHOULDN'T THE COMMISSION APPLY ACCESS CHARGES TO LOCAL CALLS?

A. The problem is that access charges are significantly inflated over cost. Using these inflated charges to establish charges for local termination would simply adopt a "poison both wells" pricing strategy. While the services might be equivalent, the consequences from the excessive rate levels would not be.

Long distance competition has survived despite high access prices for two reasons. First, incumbent LECs could not provide long distance services and, as a result, retail price levels reflected that all providers faced the same (albeit high) cost for this input. Second, long distance prices and access charges are both measured. Therefore, access costs and revenues both grow or diminish with traffic volumes.

Neither of these conditions holds true in the local exchange marketplace. Entrants will have to compete with BellSouth on day one, and BellSouth's cost to offer local service is the forward looking, long-run incremental cost of network usage, not the access charge. Second, many local exchange prices in South Carolina are flat-rated, and imposing on BellSouth's rivals a cost-structure directly at odds with retail rates